Westlaw Journal

WHITE-COLLAR CRIME

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WHAT'S INSIDE

GUILTY PLEAS

Confusion, misunderstanding spike mail-fraud plea, 7th Circuit says

Although a lawyer claimed his client was lying about a plea agreement and a trial judge approved the client's admission of guilt, a federal appeals court has allowed the defendant to withdraw his guilty plea.

***United States v. Fard*, No. 14-1221, 2015 WL 75275 (7th Cir. Jan. 17, 2015).**

Mortgage fraud defendant Siamak S. Fard told the 7th U.S. Circuit Court of Appeals that the Illinois federal trial court should have allowed him to withdraw his plea because he only pleaded guilty to wire fraud after his lawyer said the deal involved cooperating with prosecutors and no jail time.

The three-judge panel overturned the District Court, saying its review of the plea-hearing record showed Fard did not understand the elements of mail fraud, and they noted the case was "enveloped in confusion and misunderstanding."

The Oct. 17, 2011, change-of-plea hearing did not go easily. Fard balked time and again at admitting his guilt during his colloquy with U.S. District Judge John F. Grady.

"The judge became so exasperated with Fard's unwillingness to admit fault that he said, 'It's like pulling teeth. I feel I ought to have a dental license this afternoon,'" the panel noted in a written opinion.

Eventually, Judge Grady determined he had elicited enough admissions from Fard to accept his guilty plea.

A month later, Fard filed a motion to withdraw the plea, arguing that his lawyer falsely told him that the government would dismissal the case if he pleaded guilty to a mail-fraud charge and

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COMMENTARY

Ethical considerations when outside counsel conduct internal investigations

Breon S. Peace, Elizabeth Vicens and Sue S. Guan of Cleary Gottlieb Steen & Hamilton discuss the legal framework and ethics standards governing the conduct of outside counsel during internal investigations.

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Ethical considerations when outside counsel conduct internal investigations

By Breon S. Peace, Esq., Elizabeth Vicens, Esq., and Sue S. Guan, Esq.
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In 2012, a Pennsylvania appeals court reminded counsel to never turn a blind eye to corporate wrongdoing.

The court held in *Kirschner v. K&L Gates LLP*, 46 A.3d 737 (Pa. Super. Ct. 2012), that outside counsel, even if retained by a special committee of the board of directors, may have an attorney-client relationship with the company such that failure to uncover fraud during the course of an internal investigation can constitute malpractice, negligence and breach of fiduciary duty.

The case originated in 2003, when three officers resigned from drink maker Le-Nature's Inc. over concerns of CEO wrongdoing. The company's board of directors later appointed a special committee to conduct an internal investigation.

The special committee retained the firm K&L Gates LLP, which found no evidence of fraud or malfeasance. In fact, the CEO had engaged in gross misconduct and, three years later, the company declared bankruptcy. The bankruptcy trustee sued the firm, alleging legal malpractice, breach of contract, breach of fiduciary duty and negligent misrepresentation for failing to uncover the fraud the CEO and others had perpetrated.

Reversing the trial court's dismissal of the action, the appellate court held that the trustee had averred a *prima facie* case of professional negligence against the firm. The court found an attorney-client relationship between the firm and the company was sufficiently pleaded despite language in the retention letter circumscribing the firm's duties to "the special committee and … no other individual or entity, including the company."

> Liability, or at least a strong indication of unethical behavior, can result from situations where outside counsel fails to detect what they should have uncovered, or fail to disclose uncovered wrongdoing, even if unrelated to the investigative mandate.

Applying the law of Delaware, where Le-Nature's is incorporated, the court concluded that because the special committee retained the firm *on behalf of* the board — which itself was acting on behalf of the company — the firm owed a duty to the company.

In addition, the court found that the complaint sufficiently alleged the firm had acted as through it represented the company by retaining an external consultant to "assist it in rendering legal advice to [the company]," and by providing its report to an audience that included the CEO, who was not a member of the special committee.

The court also found the complaint sufficiently alleged the firm had affirmatively harmed the company by negligently allowing the CEO's fraud to continue unimpeded based on the firm's affirmative representation "that no evidence of fraud or misconduct existed." The court further held that, as alleged, the firm breached its contract to the company by limiting the scope of its investigation and failing to conduct an independent investigation.

ASSESSING POTENTIAL RISKS TO COUNSEL

The *Kirschner* case provides a number of takeaways for counsel conducting internal investigations. The case highlights how outside counsel's "gatekeeper" role and ethical obligations to act reasonably and in the best interest of the client are of particular importance in the context of internal investigations.

Indeed, the case, which settled last year, serves as a cautionary tale about two potential pitfalls: limiting the scope of an internal investigation, potentially leading to counsel's failure to uncover significant wrongdoing, and failing to understand clearly to which entity counsel owes a duty.

We are reminded that the scope of representation is not necessarily bound by the four corners of a retention letter and that counsel will be expected to meet the ever-present duty to act in the best interest of the client while conducting an investigation.

The *Kirschner* case does not squarely address the issue of what obligations investigating

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counsel have when they find potential wrongdoing outside the scope of the investigative mandate, but the decision does raise that question. Could outside counsel be subject to liability?

This article does not address the viability of such a claim, which will depend on the specific facts and circumstances, but does assess the potential risks by looking first to the ethical obligations of counsel engaged to conduct internal investigations.

Specifically, this article discusses the legal framework and ethics standards governing the conduct of outside counsel during the course of an internal investigation. While no specific rules or regulations govern the situation, where outside counsel conducting an investigation uncovers wrongdoing unrelated to the original investigative mandate, our review leads us to conclude that a prudent lawyer should look to the ethics obligations outlined in the Model Rules of Professional Conduct and Section 307 of the Sarbanes-Oxley Act for guidance.

Based on our survey of the ethical and legal framework, we believe that liability, or at least a strong indication of unethical behavior, can result from situations where outside counsel fail to detect what they should have uncovered, or fail to disclose and/or follow up on uncovered wrongdoing, even if unrelated to the investigative mandate. At a minimum, counsel that finds something should say something.

RELEVANT FRAMEWORK: RULES AND LAWS

Ethics rules and standards

The ethics rules' guiding principle on the conduct of outside counsel retained to handle an internal investigation is the requirement to always act reasonably and in the best interest of the client. This duty exists whether the client is a public or nonpublic company, whether management or a special committee retained counsel, and regardless of the precise scope of the representation.

> Disclosure is prudent even if the wrongdoing is not strictly related to the investigative mandate or might be unrelated to the representation in general, especially if the failure to disclose might harm the company.

AMERICAN BAR ASSOCIATION MODEL RULES OF PROFESSIONAL CONDUCT

Rule 1.13 of the American Bar Association Model Rules of Professional Conduct provides relevant guidance:

> (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.
>
> (c) [I]f, despite the lawyer's efforts … the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and … the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information … but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization."

In addition, Rule 1.4 provides that a lawyer shall "keep the client reasonably informed about the status of the matter." And Rule 1.2(c) provides that counsel, with the consent of client, "may limit the scope of the representation if the limitation is reasonable under the circumstances."[1]

As an initial matter, if counsel uncovers wrongdoing related to the representation of the client that might harm the company, Rule 1.13(b) requires counsel to proceed as is "reasonably necessary in the best interest of the organization." Rule 1.0(h) defines "reasonably" as the conduct of a "reasonably prudent and competent lawyer." A lawyer's knowledge of wrongdoing may be inferred from the circumstances and, importantly, Rule 1.13 cmt says "a lawyer cannot ignore the obvious."[2]

The rules make clear that "[i]f a constituent persists in conduct contrary to the lawyer's advice," review by a higher authority "will be necessary," and if the matter is of "sufficient seriousness," referral to a higher authority may be necessary. And "[e]ven in circumstances where a lawyer is not obligated by Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client … matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization."

Overall, the rules mandate that an attorney cannot "ignore the obvious." And taken together, Rules 1.2, 1.4 and 1.13 suggest it would be imprudent to ignore, not to follow up on, or not disclose "the obvious." Failing to follow up on wrongdoing *within* the scope of the investigative mandate likely would be contrary to a lawyer's ethical obligations under *Kirschner*. *See Kirchner 46 A.3d at 756*. The rules also support the conclusion that counsel conducting internal investigations should not ignore potential wrongdoing, even if outside the scope of the investigation.

At bottom, whether an attorney conducting internal investigations must disclose or follow up on suspected misconduct depends on the nature of the misconduct, the reasonableness of the attorney's response, the scope of the representation and the potential harm to the company. But in general, disclosure is prudent even if the wrongdoing is not strictly related to the investigative mandate or might be unrelated to the representation, especially if the failure to disclose might harm the company.

Section 307 of Sarbanes-Oxley

Section 307 of the Sarbanes-Oxley Act of 2002, Pub. L. 107–204, and the Securities and Exchange Commission's implementing rules, 17 C.F.R. § 205, require lawyers representing issuers, i.e., those appearing and practicing before the SEC, who "become[] aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer" to "report such evidence" to the issuer's CEO or chief legal officer.

The lawyer must then evaluate whether the response taken by the CEO and the chief legal officer is appropriate.[3] An attorney who does not reasonably believe it was appropriate is obligated to report evidence of the material violation to the issuer's audit committee, another committee of independent directors or the board. A lawyer who reasonably believes reporting to the CEO or the chief legal officer would be futile may report directly to the board, audit committee or independent board committee.[4] Finally, if counsel believes no "appropriate response" is forthcoming, the law permits, but does not require, counsel to "noisily withdraw" from the representation, It also permits, but does not require, that counsel disclose the evidence of the material violation to the SEC.[5]

The SEC's implementing rules provide, at Section 205.2(a), that outside counsel, "in the representation of an issuer," falls within the scope of the rules. Notably, the rules explicitly refer to lawyers defending clients in SEC investigations and proceedings and do not exempt internal investigations. Under Section 205.3(b)(5) "[a]n attorney retained or directed by an issuer to investigate evidence of a material violation reported under [this section] shall be deemed to be appearing before the commission."[6]

Parsing the rule's language highlights a number of relevant issues for outside counsel. As to timing, Section 205.3(b) requires lawyers who uncover evidence of wrongdoing to report once they "become aware of evidence of a material violation." The term "become aware" is not defined, and the rules do not clarify whether this requires "actual knowledge" or if conscious avoidance or willful blindness would suffice. At a minimum, the rules mandate that a lawyer take action once put on notice of potential wrongdoing.

Second, the rules require action where an attorney becomes aware of *evidence* of a material violation. This suggests that an attorney should not wait to become certain that a violation has occurred. Rather, Section 205.2(e) defines "evidence" as information that a "prudent and competent attorney" would conclude constituted "credible evidence" that a material violation is "reasonably likely" to "ha[ve] occurred, is ongoing, or is about to occur."

The SEC has clarified that reasonable likelihood requires "more than a mere possibility" of a material violation, "but it need not be 'more likely than not.'" *See* Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6,302. Thus, to act in a "prudent and competent" manner, an attorney presented with evidence of potential wrongdoing, even if outside the scope of the investigation, would have to undertake some evaluation to determine whether a violation has or will occur.

> The ethics rules and relevant guidance indicate that counsel should report potential misconduct discovered during an investigation, even if that conduct is outside the scope of the investigation.

Third, the SEC's definition of "material violation" in Section 205.2(e) encompasses both federal and state securities laws, as well as material breaches of a fiduciary duty arising under federal or state law. That the SEC has brought within its reach breaches of fiduciary duty means that attorneys conducting investigations of issuers could face enforcement actions for violations beyond those typically under the SEC's supervision.

Finally, Section 307 was enacted to impose on attorneys a gatekeeper function similar to that imposed on accountants by Section 10A of the Securities Exchange Act, 15 U.S.C. § 78j–1. Therefore, Sarbanes-Oxley and its implementing rules require attorneys to conduct some evaluation to ensure no violation has occurred and to assess whether management or the board has responded appropriately to evidence of a material violation.

These requirements, in the context of an internal investigation, affirm and supplement the overarching ethical duty under the ABA rules to act in the best interest of the company and never willfully to ignore misconduct. They also suggest that attorneys representing issuers should document efforts taken to evaluate potential wrongdoing falling outside the scope of the issues originally giving rise to the investigation, as well as the response that corporate authorities provide upon receiving the attorney's report of the wrongdoing.

CONCLUSION

Outside counsel conducting internal investigations must adhere to their many ethical obligations associated with the engagement. The ethics rules and relevant guidance indicate that counsel should report potential misconduct discovered during an investigation, even if the conduct is outside the scope of the investigation. To ensure they can "say something when they see something," lawyers conducting the investigation should make certain they have the mandate to conduct a robust investigation.

Further, outside counsel should be prepared to address investigation findings unrelated to the initial issues that gave rise to the investigation. Counsel should consider what their disclosure obligations may be, both within the company and externally, depending on the nature of the wrongdoing. Under both the ABA's Model Rules and the SEC's "reporting up" requirements, such disclosure may be mandated.

In any event, the identification and disclosure of potential wrongdoing may be in the best interests of the client. Failure to disclose potential wrongdoing to the company may result in not only harm to the company, but in potential liability for investigating counsel. WJ

NOTES

1 Although the client can agree to limit the scope of representation, e.g., if the client has limited objectives in pursuing the investigation, "the limitation must be reasonable under the circumstances" according to Rule 1.2 cmt. So while it may be prudent to circumscribe the investigative inquiry to avoid an unfocused or runaway investigation, any limitation cannot allow counsel to ignore wrongdoing or otherwise relieve it of its duty to provide competent representation.

2 Rule 1.13 cmt also notes that "[i]n determining how to proceed … [counsel] should give due consideration to the seriousness of the violation and its consequences, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters, and any other relevant considerations."

3 Under 17 C.F.R. § 205.2(b), an issuer's response is "appropriate" where it reasonably causes the attorney to believe that no material violation has

or will occur, that the issuer has adopted remedial measures or that the issuer, with the board's consent, has authorized an investigation. The SEC has clarified that counsel are "permit[ted] to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what is an appropriate response is reasonable." *See* Implementation of Standards of Professional Conduct for Attorneys, SEC Final Rule, No. 33-8185 (September 2003), *available at* http://www.sec.gov/rules/final/33-8185.htm. Notably, by requiring an attorney to determine whether a response was "reasonably appropriate," the SEC puts the burden on attorneys to provide a basis for their conclusions.

[4] The attorney may report to a qualified legal compliance committee, if one has been established. Under 17 C.F.R. § 205.2(k), the QLCC must comprise at least one member of the audit committee (or an equivalent committee of independent directors) and two other independent board members. The QLCC must be duly established by the board and have the authority to investigate and report any evidence of material violations. After an attorney reports to the QLCC, it assumes responsibility for the issuer's compliance with the reporting-up rules such that the attorney is no longer responsible for assessing the appropriateness of the issuer's response.

[5] The rules permit an attorney to reveal to the SEC, without consent, confidential information to the extent the attorney reasonably believes doing so is necessary to prevent the commission of a material violation likely to cause substantial injury to the issuer or its investors or perjury in an SEC investigation or administrating proceeding, or to rectify consequences of a material violation. Numerous states have narrower permissive disclosure rules. Rule 1.6 of the New York Rules of Professional Conduct permits disclosure only if a lawyer reasonably believes doing so is necessary to prevent death, substantial bodily harm, or commission of a crime. Rule 3-100 of the California Rules of Professional Conduct authorizes disclosure only if necessary to prevent death, substantial bodily harm or commission of a crime and only after the lawyer has made a good faith effort to dissuade the client from committing the crime. Many states have further warned attorneys in their state away from taking advantage of the SEC's permissive disclosure rules. *See, e.g.*, Ethics Alert: The New SEC Attorney Conduct Rules v. California's Duty of Confidentiality (Spring 2004), *available at* http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=7xTdfWYEC3k%3D&tabid=834; Committee on Professional Ethics, NYCLA, Formal Opinion 746, Ethical Conflicts Caused by Lawyers as Whistleblowers under the Dodd-Frank Wall Street Reform Act of 2010, at 9 (Oct. 7, 2013), *available at* https://www.nycla.org/siteFiles/Publications/Publications1647_0.pdf.

[6] The only exception to reporting evidence of a material violation under 17 C.F.R. § 205(b) is where the attorney was retained to assert a "colorable defense" on behalf of the issuer relating to the material violation and the chief legal officer provides timely reports to the board on the proceeding's progress. The "colorable defense" exception applies, however, only where the board is aware and has consented to the attorney not reporting the findings pursuant to the rules. *See* Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6,296, 6,301 (Feb. 6, 2003).

Mail fraud

CONTINUED FROM PAGE 1

cooperated with their ongoing investigation. The original lawyer then withdrew from the case.

During the course of the case, a second lawyer also quit, and a third attorney was obtained. Over that time, two new motions to withdraw the guilty plea were filed, both arguing that in addition to his belief that the government had agreed to drop the charges, Fard did not understand the mail-fraud charge to which he had pleaded guilty.

"The judge's inquiry and the defendant's own statements during the plea hearing is where this plea runs into the biggest challenges," the 7th Circuit said.

The judge held an evidentiary hearing June 5, 2012, on the alleged false plea-agreement representations. The original lawyer denied telling Fard he had a plea agreement of any kind, but did admit to "jokingly telling Fard that the indictment might be dismissed if Fard became a spy in Iran," the opinion says.

The judge determined Fard was lying about the plea deal terms and he bumped up Fard's penalty for obstruction of justice and sentenced him to seven years in prison Jan. 22, 2014.

This appeal followed.

In overturning the District Court and vacating the guilty plea, the 7th Circuit said, "The judge's inquiry and the defendant's own statements during the plea hearing is where this plea runs into the biggest challenges."

A defendant must knowingly admit guilt for a guilty plea to be legally valid.

The appeals panel said a "careful review" of the colloquy with the judge showed that Fard did not understand his actions had been unlawful and that the court failed to explain how a fraudulent scheme worked in a mail-fraud case.

The circuit judges said that, based on the record, it was "impossible" to determine precisely what Fard had admitted to during the plea hearing. They also noted the sentencing hearing was further complicated by the fact that "English was not his native language."

As for the alleged promise of a favorable plea deal, the 7th Circuit was not as quick as the District Court judge to shut Fard down. The panel said the record showed that plea-deal negotiations were most likely in progress at the time of the change-of-plea hearing and Fard's claim "is not farfetched." WJ

Related Court Document:
Opinion: 2015 WL 75275

See Document Section A (P. 19) for the opinion.